



1 FINANCE AND ADMINISTRATION CABINET

2 Department of the Controller

3 Office of Financial Management

4 (Amendment)

5 200 KAR 14:011. Qualified Investments.

6 RELATES TO: KRS 42.500(9)-(14), 42.520, 42.525

7 STATUTORY AUTHORITY: KRS 42.500(10), 42.520(2), 42.525

8 NECESSITY, FUNCTION, AND CONFORMITY: KRS 42.500(10) requires the State In-
9 vestment Commission to promulgate administrative regulations for the investment and reinvest-
10 ment of state funds. KRS 42.520(2) requires the commission to promulgate administrative regu-
11 lations concerning the assignment of priorities to public depositories. KRS 42.525(1) requires the
12 commission to promulgate administrative regulations for the investment and reinvestment of
13 state funds and the acquisition, retention, management, and disposition of investments. This ad-
14 ministrative regulation establishes the standards that govern the commonwealth's investment and
15 cash management programs.

16 Section 1. Definitions. (1) "Commission" means the State Investment Commission.

17 (2) "Floating rate" means that the interest rate:

18 (a) That is paid on the specific security changes periodically on a pre-established schedule;

19 (b) May be tied directly to an index plus some spread or margin; and

20 (c) Includes hybrid adjustable rate mortgages if the first repricing date is less than six (6)
21 years from the issuance date.

(3) "Hedge" means a position in a financial instrument taken to minimize or eliminate the risk associated with an existing instrument or portfolio of instruments.

(4) "Interest rate swaps" means an agreement governed by an International Swap and Derivatives~~[Dealers]~~ Association master contract between two (2) parties to exchange, or have the conditional right to exchange, specified cash flows.

(5) "NRSO"~~["Nationally recognized rating agency"]~~ means "Nationally Recognized Statistical Ratings Organization", which is a credit rating agency that is registered with~~[(NRSRO) as designated by]~~ the Securities and Exchange Commission, and which provides its opinion on the creditworthiness of an entity and the financial obligations issued by that entity.

(6) "Office" means the Office of Financial Management.

(7) "Options" means a contract that provides the right, but not the obligation, to buy or sell a specific amount of a security within a predetermined time period and includes specific bonds or notes, an exchange traded futures contract, or the cash value of an index.

(8) "Pools" means the investment pools that are managed by the Office of Financial Management, under the guidance of the commission.

Section 2. The commission shall:

(1) Not invest state funds in an institution or instrument that it deems unsafe and a threat to the security of state funds;

(2) Maintain adequate liquidity to meet the cash needs of the state;

(3) Within the limits established by this administrative regulation, invest in securities that maximize yield or return to the Commonwealth~~[- or (4) Not borrow money to enlarge the pool].~~

Section 3. The commission may: (1) Engage in securities lending;

(2) Allow inter-pool transfers to meet short term cash needs; or

1 (3) Within the limited term pool, if borrowing exceeds thirty-three (33) percent of the value of
2 the pool's total assets resulting from a change in values of net pool assets at any time, the pool
3 shall then reduce borrowing to no more than thirty-three (33) percent within three (3) business
4 days and shall continue to use prudence in bringing the percentage of borrowing back into con-
5 formity.

6 Section 4[3]. Interest earned on the cash balances shall be calculated daily on an accrual basis.

7 Section 5[4]. Investment Criteria. (1) The criteria to determine the amount of funds per in-
8 vestment instrument shall be the:

9 (a) Liquidity needs of the state in aggregate as budgeted;

10 (b) Rates available per instrument; and

11 (c) Safety of principal and interest.

12 (2) An investment instrument shall qualify if it is specified by:

13 (a) KRS 42.500;

14 (b) This administrative regulation;

15 (c) 200 KAR 14:081; or

16 (d) 200 KAR 14:091.

17 Section 6[5]. Investment Securities. The commission shall invest only in the following securi-
18 ty types:

19 (1) U.S. Treasury, agency, and government sponsored entity agency securities with a maturity
20 of less than seven (7) years, or an embedded put of less than three (3) years.

21 (2) Mortgage pass-through securities issued by U.S. government agencies or by government
22 sponsored entities, including Government National Mortgage Association, Fannie Mae, Freddie
23 Mac, and~~government national mortgage association, Federal National Mortgage Association,~~

~~Federal Home Loan Mortgage Corporation,~~ Small Business Administration~~[-and Student Loan Marketing Association]~~ with an average life of less than four (4) years at the time of purchase, using Bloomberg consensus prepayment projections, if available, or other reasonable prepayment assumptions if there is no consensus. The commission may hold pass-throughs purchased under this subsection which have an average life of less than six (6) years, using Bloomberg consensus prepayment projections, if available, or other reasonable prepayment assumptions if there is no consensus.

(3) Real estate mortgage investment conduit obligations, as defined by the Internal Revenue Code, also known as collateralized mortgage obligations, or CMOs, rated in the highest category by an NRSRO~~[A or higher by a nationally recognized rating agency]~~ with an average life of less than four (4) years at the time of purchase, using Bloomberg consensus prepayment projections, if available, or other reasonable prepayment assumptions if there is no consensus. The commission may hold CMOs purchased under this subsection which have an average life of less than six (6) years, using Bloomberg consensus prepayment projections, if available, or other reasonable prepayment assumptions if there is no consensus.

(4) Asset-backed securities (ABS) rated in the highest category by an NRSRO~~[a nationally recognized rating agency]~~ with an average life of four (4) years or less.

(5) U.S. dollar denominated corporate and Yankee securities issued by foreign and domestic issuers, rated in one (1) of the three (3) highest categories by an NRSRO~~[A or higher by a nationally recognized rating agency]~~, with a maturity not longer than five (5) years, or an embedded put of less than three (3) years.

(6) U.S. dollar denominated sovereign debt rated in one (1) of the three (3) highest categories by an NRSRO~~[A1 or higher by a nationally recognized rating agency]~~, with a maturity not to exceed five (5) years.

(7) Money market securities, including:

(a) Commercial paper;

(b) Certificates of deposit;~~[and]~~

(c) Bankers' acceptances issued by banks having the highest short-term rating by an NRSRO~~;~~~~[Eurodollars and time deposits rated in the highest short term rating with assets in excess of one (1) billion dollars and bankers' acceptances rated A or higher.]~~

(d) Maturities shall be limited to 180 days~~[six (6) months]~~ for bankers' acceptances and 270 days~~[nine (9) months]~~ for all other money market securities.

(8) Repurchase~~[and reverse repurchase]~~ agreements collateralized at a minimum of 102 per cent (marked to market daily) with treasuries, agencies, and agency~~[collateralized]~~ backed obligations that meet the requirements established by subsection (4) of this section, with a maximum maturity of one (1) year if executed with approved broker-dealers as provided by Section 8 of this administrative regulation and a maximum of three (3) years for the Kentucky Bank Repurchase Program participants.

(9) Municipal obligations rated in one (1) of the three (3) highest categories by an NRSRO~~[A1 or higher by a nationally recognized rating agency]~~, with a maturity not to exceed five (5) years. The maturity and credit restriction shall be waived for obligations issued by the Commonwealth of Kentucky or any entity within the Commonwealth of Kentucky.

(10) Mutual funds in~~[which at least ninety (90) percent of]~~ the underlying holdings of the fund are in securities in which the pools could invest directly.

(11) In meeting credit standards listed previously in this section, the lowest rating issued by an NRSRO shall be used to determine compliance. The commission, at a minimum on an annual basis, shall determine which NRSRO's shall be used~~[Any floating rate securities which would otherwise qualify under this section except for maturity or average life restrictions].~~

Section 7~~[6]~~. Limits on Investment Securities. (1) U.S. agency mortgage backed securities and collateralized mortgage obligations shall not exceed twenty-five (25) percent of total pool assets in aggregate.

(2) Asset-backed securities shall not exceed twenty (20) percent of total pool assets.

(3) U.S. dollar denominated corporate and Yankee and sovereign securities issued by foreign and domestic issuers shall not exceed thirty-five (35)~~[twenty five (25)]~~ percent of an individual pool or \$25,000,000 per issuer within an individual pool~~[and \$25,000,000 per issuer]~~, inclusive of commercial paper, bankers' acceptances, and certificates of deposit unless:

(a) These securities are guaranteed by the full faith and credit of the United States government; or

(b) These securities were purchased between February 19, 2009 and March 31, 2009.

(4) U.S. dollar denominated sovereign debt shall not exceed five (5) percent of any individual portfolio and \$25,000,000 per issuer.

(5) No more than ten (10) percent of total pool assets shall be invested in a single mutual fund.

(6) The credit and diversification requirements documented herein shall apply at the time of purchase based on book value for the Limited Term Pool and market value for other pools.

(7) The limits set forth in this section may be waived by unanimous vote of the commission.

1 Section 8[7]. Risk Management. The pools may utilize interest rate swaps, over-the-counter
2 and exchange traded U.S. Treasury contracts and options to manage the portfolio's exposure to
3 interest rate risk. These instruments shall only be used if the results are demonstratively superior
4 to cash market transactions.

5 Section 9[8]. Pools and Operating Procedures. (1)(a) The limited-term pool shall be managed
6 to meet the requirements of Section 2a.7 of the Investment Company Act of 1940. Terms used in
7 this section shall have the definitions prescribed in the Investment Company Act of 1940.~~[Except~~
8 ~~for the Budget Reserve Trust Fund, state funds held in accounts the interest of which accrues to~~
9 ~~the General Fund shall be placed in the short-term pool or the intermediate pool.]~~

10 (b) The limited~~[short]~~-term pool shall not purchase a security with a final maturity~~[duration]~~
11 exceeding 397 days, except for governmental securities, which may have a final maturity of up
12 to 762 days~~[one (1) year]~~.

13 (c) The weighted average maturity, adjusted for interest rate resets and demand fea-
14 tures,~~[duration of the short-term pool]~~ shall not exceed sixty (60)~~[ninety (90)]~~ days; and the
15 weighted average life, adjusted for demand features only but not interest rate resets, shall not ex-
16 ceed 120 days.

17 (d) At a minimum:

18 1. Ten (10) percent of the pool shall be invested in cash, direct obligations of the U.S. gov-
19 ernment or securities that mature or are subject to a demand feature payable within one (1) busi-
20 ness day; and

21 2. Thirty (30) percent of the pool shall be invested in cash, direct obligations of the U.S. gov-
22 ernment, government agency discount note maturing in sixty (60) days or less or securities that
23 mature or are subject to a demand feature payable within five (5) business days.

1 (e) All securities purchased for the pool shall be rated by an NRSRO.

2 (f) No more than five (5) percent of the pool shall be invested in illiquid securities.

3 (g) No more than three (3) percent of the pool shall be invested in second tier securities and
4 no more than five-one hundredths (.05) percent of the pool shall be invested in a second tier se-
5 curity issuer.

6 (h) The net asset value of pool shares shall be computed using the amortized cost method of
7 valuing the pool's investments.

8 (i) The shadow net asset value using the market value of pool holdings shall be computed no
9 less than monthly and made public within sixty (60) days of the calculation date.

10 (j) Stress testing of the pool based on redemption and changes in market value shall be per-
11 formed no less than quarterly and reported to the commission.

12 (k) Monthly portfolio listings shall be published to a public Web site and shall remain availa-
13 ble for no less than six (6) months.

14 (2)(a) Except as provided by paragraph (b) of this subsection, state funds held in agency or
15 university accounts, the interest of which accrues to the agency or university, shall be placed in
16 the intermediate pool.

17 (b) These funds may be placed in the limited~~[short]~~-term pool, if the commission determines
18 that the liquidity needs of an agency require shorter term investment.

19 (c) The duration of the intermediate pool shall not exceed three (3) years.~~[(3)(a) Bond~~
20 ~~proceeds from state issued bonds may be placed in the bond proceeds pool.~~

21 ~~(b) The bond proceeds pool shall consist of U.S. Treasury, agency and government sponsored~~
22 ~~entity notes, bills and bonds, and repurchase agreements.~~

1 ~~(4)(a) The portion of the Budget Reserve Trust Fund, the disposition of which the approval of~~
2 ~~the General Assembly is required, and agency funds which the commission and agency deter-~~
3 ~~mine need not be expended for a period of two (2) years, shall be placed in the long term pool.~~

4 ~~(b) The duration of the long term pool shall not exceed four and one half (4.5) years.]~~

5 Section 10[9]. Approved Broker-Dealers. (1) A broker-dealer who was approved by the
6 commission prior to the effective date of this administrative regulation shall be considered an
7 approved broker-dealer.

8 (2) Except as provided by subsection (1) of this section, a broker-dealer shall be approved by
9 the commission if the broker-dealer has met the requirements established by subsection (3), (4),
10 or (5) of this section, as applicable.

11 (3) An approved broker-dealer shall be a broker dealer who meets one (1) of the following
12 qualifications:

13 (a) Is a primary dealer of the Federal Reserve~~[rated A1 P1 by a nationally recognized rating~~
14 ~~agency];~~

15 (b) Maintains an office in Kentucky, and has either \$25,000,000 in excess net capital or has
16 trades that are guaranteed by a primary dealer of the Federal Reserve~~[who is rated A1 P1 or~~
17 ~~higher by a nationally recognized rating agency];~~ or

18 (c) Has a minimum of \$100,000,000 in excess net capital.

19 (4) An approved broker-dealer for repurchase agreements shall:

20 (a)~~[Be rated A1 or higher by a nationally recognized rating agency;~~

21 ~~(b)]~~ Have transaction amounts limited to his excess net capital;

22 ~~(b)]~~~~(c)]~~ Have executed the:

1 1. Public Securities Association Master Repurchase Agreement prior to entering into a repur-
2 chase transaction; and

3 2. Appropriate third-party custodial agreement or Custodial Undertaking~~[undertaking]~~ in con-
4 nection~~[Connection]~~ with Master Repurchase Agreement for tri-party repurchase agreements;
5 and

6 (c) ~~[(d)]~~ Be primary dealer of the Federal Reserve~~[who is rated A1-P1 or higher by a national-~~
7 ~~ly recognized rating agency]~~.

8 (5) An approved broker-dealer for hedge vehicles shall:

9 (a) Have at least \$100,000,000 in excess net capital;

10 ~~(b)[Be rated A1 or higher by a nationally recognized rating agency;~~

11 ~~(e)]~~Have market value transactions limited to his excess net capital; and

12 (c)~~[(d)]~~ Have executed the:

13 1. International Swap and Derivatives~~[Dealers']~~ Association Agreement prior to the imple-
14 mentation of a swap; and

15 2. Commonwealth of Kentucky Master Agreement, Over-the-counter Option Transactions -
16 U.S. Treasury Securities, prior to the implementation of an over the counter option transaction.

17 (6)(a) Within 180 days of the end of each broker-dealer's fiscal year, a broker-dealer shall
18 submit a copy of the broker-dealer's audited financial statements for that fiscal year.

19 (b) A broker-dealer who wishes to be approved by the commission as an approved broker-
20 dealer shall submit a copy of the broker-dealer's current audited financial statements

21 (7) Notwithstanding the broker-dealer requirements described in this section, the state may
22 purchase securities directly from the issuer.

Section 11[40]. Incorporation by Reference. (1) The following material is incorporated by reference:

(a)[~~"Commonwealth of Kentucky, Bond Proceeds Pool, Prospectus, (12/97)";~~
(b)~~"Commonwealth of Kentucky, Short-term Pool, Prospectus, (12/97)";~~
(c)~~"Commonwealth of Kentucky, Intermediate-term Pool, Prospectus, (12/97)";~~
(d)~~"Commonwealth of Kentucky, Long-term Pool, Prospectus, (12/97)";~~
(e)] "Securities Industry and Financial Markets Association Master Repurchase Agreement", [12/08[)];

(b)[(f)] "Custodial Undertaking in Connection with Master Repurchase Agreement, Bank of New York", [12/08[)];

(c)[(g)] "Custodial Undertaking in Connection with Master Repurchase Agreement, Chase Manhattan", [12/08[)];

(d)[(h)] "International Swap and Derivatives[Dealers'] Association Agreement", [12/02[)];

and

(e)[(i)] "Commonwealth of Kentucky Master Agreement, Over-the-counter Option Transactions - U.S. Treasury Securities", [12/97[)].

(2) This material may be inspected, copied, or obtained, subject to applicable copyright law, at State Investment Commission, Suite 76, Capitol Annex, Frankfort, Kentucky 40601, Monday through Friday, 8 a.m. to 4:30 p.m.

Approved:

F. Thomas Howard, Executive Director
Department of the Controller
Office of Financial Management

Date

PUBLIC HEARING AND PUBLIC COMMENT PERIOD

A public hearing on this administrative regulation shall be held on October 24, 2012, from 10:00 a.m. to 12:00 p.m., in Room 383, Capitol Annex Building, Frankfort, Kentucky 40601. Individuals interested in being heard at this hearing shall notify this agency in writing at least five (5) workdays prior to the hearing, of their intent to attend. If no notification of intent to attend the hearing is received by the required date, the hearing may be cancelled. This hearing is open to the public. Any person who wishes to be heard will be given an opportunity to comment on this proposed administrative regulation. A transcript of the public hearing will not be made unless a written request for a transcript is made. If you do not wish to be heard at the public hearing, you may submit written comments on the proposed administrative regulation. Written comments shall be accepted until October 31, 2012. Send written notification of intent to be heard at the public hearing or written comments on the proposed administrative regulation to the contact person.

CONTACT PERSON: DeVon Hankins, Policy Advisor, Office of General Counsel, Finance and Administration Cabinet, 392 Capitol Annex, Frankfort, Kentucky, 40601, (502) 564-6660 (telephone), (502) 564-9875 (fax).

REGULATORY IMPACT ANALYSIS AND TIERING STATEMENT

Administrative Regulation #: 200 KAR 14:011

Contact person: DeVon Hankins, Policy Advisor and Legislative Liaison, Office of General Counsel, Office of the Secretary, Finance and Administration Cabinet, 392 Capitol Annex, Frankfort, Kentucky, 40601, (502) 564-6660 (telephone), (502) 564-9875 (fax)

(1) Provide a brief summary of:

(a) What this administrative regulation does: This regulation provides the direction for investment of state funds required by KRS 42.500 (10).

(b) The necessity of this administrative regulation: This regulation is required to place limitations on investment activities in order to limit the risk of loss of state funds through imprudent investment decisions.

(c) How this administrative regulation conforms to the content of the authorizing statutes: KRS 42.500 (10) specifies particular requirements for this administrative regulation such as limits on the maturity of investments. This regulation specifies those particular limitations.

(d) How this administrative regulation currently assists or will assist in the effective administration of the statutes: This administrative regulation provides guidance on the investment of state funds and requires prudent investment activities which will limit the exposure of state funds to investment losses.

(2) If this is an amendment to an existing administrative regulation, provide a brief summary of:

(a) How the amendment will change this existing administrative regulation: This regulation establishes limitations on the credit of entities in which the state may invest. This amendment tightens those restrictions for all security types while allowing for a larger investment in certain entities. The amendment also conforms the Limited Term pool restrictions to Securities and Exchange Commission Rule 2a-7. It also updates terminology to current market standards.

(b) The necessity of the amendment to this administrative regulation: This amendment brings the regulation up to the standards adopted by the State Investment Commission.

(c) How the amendment conforms to the content of the authorizing statutes: The amendment is compliant with KRS 42.500 (10).

(d) How the amendment will assist in the effective administration of the statutes: The amendment further clarifies investment activities to reduce the risk of loss of state funds.

(3) List the type and number of individuals, businesses, organizations, or state and local governments affected by this administrative regulation: This regulation only affects actions by the Office of Financial Management.

(4) Provide an analysis of how the entities identified in question (3) will be impacted by either the implementation of this administrative regulation, if new, or by the change, if it is an amendment, including:

(a) List the actions that each of the regulated entities identified in question (3) will have to take to comply with this administrative regulation or amendment: Personnel in OFM will need to assure investment purchases meet the newly modified requirements set forth in this amendment. In addition, certain additional reporting/monitoring functions are required which will be performed by current staff.

(b) In complying with this administrative regulation or amendment, how much will it cost each of the entities identified in question (3): No costs.

(c) As a result of compliance, what benefits will accrue to the entities identified in question (3): This amendment clarifies certain requirements for the Office of Financial Management and brings regulation into conformity with Securities and Exchange Commission Rule 2a-7.

(5) Provide an estimate of how much it will cost the administrative body to implement this administrative regulation:

(a) Initially: \$0

(b) On a continuing basis: \$0

(6) What is the source of the funding to be used for the implementation and enforcement of this administrative regulation: None needed.

(7) Provide an assessment of whether an increase in fees or funding will be necessary to implement this administrative regulation, if new or by the change if it is an amendment: No increase needed.

(8) State whether or not this administrative regulation established any fees or directly or indirectly increased any fees: This amendment does not establish or increase any fees.

(9) TIERING: Is tiering applied? (Explain why or why not): There is no tiering because it is not applicable.

FISCAL NOTE ON STATE OR LOCAL GOVERNMENT

Regulation Number: 200 KAR 14:011

Contact Person: DeVon Hankins, Policy Advisor, Office of General Counsel, Finance and Administration Cabinet, 392 Capitol Annex, Frankfort, Kentucky, 40601

Phone number: (502) 564-6660 (telephone), (502) 564-9875 (fax)

(1) What units, parts, or divisions of state or local government (including cities, counties, fire departments, or school districts) will be impacted by this administrative regulation?

This regulation only affects the investment actions of the Office of Financial Management.

(2) Identify each state or federal statute or federal regulation that requires or authorizes the action taken by the administrative regulation.

KRS 42.500 requires the State Investment Commission to promulgate this regulation. Additionally, the regulation requires that the Limited Term pool be managed consistent with SEC Rule 2a-7 as required by current government accounting standard.

(3) Estimate the effect of this administrative regulation on the expenditures and revenues of a state or local government agency (including cities, counties, fire departments, or school districts) for the first full year the administrative regulation is to be in effect. None

(a) How much revenue will this administrative regulation generate for the state or local government (including cities, counties, fire departments, or school districts) for the first year?

None.

(b) How much revenue will this administrative regulation generate for the state or local government (including cities, counties, fire departments, or school districts) for subsequent years?

None

(c) How much will it cost to administer this program for the first year?

No cost.

(d) How much will it cost to administer this program for subsequent years?

No cost.

Note: If specific dollar estimates cannot be determined, provide a brief narrative to explain the fiscal impact of the administrative regulation.

Revenues (+/-):

Expenditures (+/-):

Other Explanation:

2012
200 KAR 14:011
Summary of Materials
Incorporated by Reference

Pursuant to KRS 13A.2555, the following is a summary of the material incorporated by reference in 200 KAR 14:011:

1. "Securities Industry and Financial Markets Association Master Repurchase Agreement", (12/08)", effective July 12, 2012, is a 12 page agreement that governs the relationship between the Commonwealth and it's tri-party repurchase agreement counter-parties. It is an industry standard contract.
2. "Custodial Undertaking in Connection with Master Repurchase Agreement, Bank of New York (12/08)", effective December 29, 2008, is a 22 page agreement that governs the custodial duties of the Bank of New York related to various tri-party repurchase agreements.
3. "Custodial Undertaking in Connection with Master Repurchase Agreement, Chase Manhattan (12/08)", effective December 29, 2008, is a 22 page agreement that governs the custodial duties of the Chase Manhattan related to various tri-party repurchase agreements.
4. "International Swap and Derivatives Association Agreement (12/02)", effective February 14, 2011, is a 18 page agreement that governs the relationship between the Common-

wealth and its derivatives counter-parties in connection with any interest rate swap transactions undertaken to manage the state's investment portfolio.

5. "Commonwealth of Kentucky Master Agreement, Over-the-counter Option Transactions - U.S. Treasury Securities (12/97)", effective January 14, 1998, is a 8 page agreement that governs the relationship between the Commonwealth and any Treasury Option Transaction counter-parties.

The material incorporated by reference consists of the above agreements, totaling eighty-two (82) pages.